Inflation, Deficits and Paul Volcker

By Thomas Sargent And William Silber

'We have been having inflation," Milton Friedman observed in 1978, "not because evil men at the Fed have been willfully turning the printing press, but because John Q. Public has been demanding inflation and aborting every attempt to stop inflation. We, the public, have been asking Congress to provide us with ever more goodies—yet not to raise our taxes."

How do you square this with his more famous pronouncement, "Inflation is everywhere and always a monetary phenomenon"? Friedman's answer: "Financing government spending by increasing the quantity of money is often the most politically attractive method to both presidents and members of Congress."

The Fed chairman who tamed runaway prices understood Congress's role in unleashing them.

Central banks' creating too much money has produced inflation throughout history, but the underlying force pushing them is large government deficits. Paul Volcker, who served as Federal Reserve chairman from 1979 through 1987, is usually credited with conquering America's worst peacetime inflation, but he did so by forcing fiscal integrity on Congress.

Volcker testified before the Senate Budget Committee in 1981 urging Congress to cut the deficit to lower both inflation and interest rates. At the first meeting of the Federal Reserve's policy-making committee in 1982, Volcker confidant Gerald Corrigan, the Minneapolis Fed president, warned his colleagues who were considering abandoning monetary restraint, "If the perception is that we really are easing, any prospect of being able to do better on the fiscal side is weakened." He added, "That creates the impression that we are going to sit here and monetize all that debt."

In 1984, at Senate Banking Committee hearings, Sen. John Heinz of Pennsylvania asked Volcker whether he was prepared "to help bring about the necessary crisis through your continued restrictive monetary policy so that we deal with the deficit." When Volcker said no, Heinz persisted: "But it might be an inevitable consequence." To which Volcker responded, "All right."

On Dec. 11, 1985, Congress passed the Gramm-Rudman-Hollings Balanced Budget Act, designed to require across-the-board cuts in federal spending if Congress fell short of predetermined targets. "It was a bad idea whose time had come," said Sen. Warren Rudman of New Hampshire. Sen. Daniel Patrick Moynihan of New York called it "a suicide pact."

The day after the legislation passed, Sen. Phil Gramm of Texas called Volcker and reminded him of the Fed's role in forcing budget sanity on the country: "With tight money policy for the government, we can now afford an easier money policy for the private sector." Volcker responded, "Congratulations on the legislation." That was all he said, but the market also spoke: The 10-year Treasury bond yield declined into single digits as a result of the legislation.

The lesson for the current situation is clear. Without decreasing the budget deficit, combating inflation with monetary policy is like entering a heavyweight championship competition with one hand tied behind your back.

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